I found that Mr. Frick acted recklessly and violated applicable professional standards by certifying that PeopleSoft's financial statements for fiscal years 1994 through 1999 were the subject of independent audits for the reasons stated previously. If a reviewing authority should determine that this conduct does not satisfy the definition of reckless conduct, it meets the standard of highly unreasonable conduct.

Negligent Conduct

I find that EY committed repeated instances of unreasonable conduct, each of which resulted in violations of applicable professional standards, that indicate a lack of competence to practice before the Commission. See Rule 102(e)(1)(iv)(B)(2) of the Commission's Rules of Practice and Section 4C of the Exchange Act. The Commission has defined the term "unreasonable" under Rule 102(e)(1)(iv)(B)(2) as "an ordinary or simply negligence standard." Amendment to Rule 102(e), 68 SEC Docket at 712. The term "repeated instances" means "more than once" and can be satisfied by "as few as two separate instances of unreasonable conduct occurring within one audit, or separate instances of unreasonable conduct within different audits." Id. Mr. Frick was reckless in certifying that PeopleSoft's audits from fiscal years 1994 through 1999 were done in accordance with GAAS and that EY was independent. If a reviewing authority should determine that the conduct described above does not satisfy the definition of reckless or highly unreasonable conduct, at a minimum, it comes within the definition of negligent conduct.

The overwhelming evidence is that during the relevant period, EY's day-to-day operations were profit-driven and ignored considerations of auditor independence in business relationships with PeopleSoft. EY's partners shared in the pooled revenues of the firm's three practice areas, and each EY partner was evaluated annually on his or her achievement toward five preset goals, one of which was sales. EY did not give its employees any formal training on a regular basis concerning the independence rules on business dealings with an audit client. Most of the EY employees who testified relied on the Guidelines and EY used them in the information it provided to PeopleSoft for its Partner Profile; however, EY never formally endorsed these directives. The evidence demonstrates that not everyone received the Guidelines. Those who received copies interpreted them differently. Further, EY made no firm-wide attempt at educating its employees about them to assure a consistent interpretation.

EY had no procedures in place that could reasonably be expected to deter violations and assure compliance with the rules on auditor independence with respect to business dealings with audit clients. Mr. Coulson expected EY employees to seek his advice; however, there is no evidence that Mr. Fridley and the other Consulting partners ever sought his advice. EY's national office that addressed independence issues is not mentioned in the voluminous communications in this record that pertain to EY's implementation efforts. The only oversight mechanism to enforce the "culture of consultation" that allegedly existed was a self-reporting form on which EY partners and employees were required to report whether they abided by the firm's independence policies. The evidence is persuasive that it is not effective to rely on members of an accounting firm to self-report on the issue of independence without the threat of random verification. (April 8, 2003, Tr. 37-40.) As an expert in audits, EY knew or should have

known that a worldwide firm with thousands of employees could not rely on voluntary compliance. The fact that EY relied on self-interested people to voluntarily raise independence issues and to file forms where positive responses would cause a loss of income are strong indications that EY was negligent.

V. SANCTIONS

Based on the findings in this Initial Decision, I find the following sanctions necessary in the public interest.

Cease and Desist

Section 8A of the Securities Act and Section 21C of the Exchange Act authorize the Commission, after it has found a violation of the respective statute or any rule or regulation thereunder, to require a person who has violated or caused a violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation. The Division requests that EY be ordered to cease and desist from committing any future violations of Rule 2-02 of Regulation S-X, and from causing any future violations of Sections 7(a) and 10(a) of the Securities Act, and Sections 13(a) and 14(a) of the Exchange Act, and Rules 13a-1 and 14a-3.

The Court of Appeals for the District of Columbia Circuit recently vacated a Commission order to cease and desist based on a finding that the Commission's action was arbitrary and capricious. WHX Corp. v. SEC, 2004 U.S. App. LEXIS 6942 (Apr. 9, 2004). The court found that the Commission failed to meet the evidentiary standard it had set for itself as to when to impose a cease-and-desist order, which included a finding of some risk of future violation, and that the Commission had failed to explain how a reasonable application of the KPMG factors could support imposition of an order to cease and desist. Id. at *13-20.

In KPMG, the Commission found the accounting firm had acted negligently in violating Rule 2-02 and in causing its audit client's violation of Section 13(a) of the Exchange Act and Rule 13a-1 and ordered the firm to cease and desist upon consideration of the following factors:

> Along with the risk of future violations, we will continue to consider our traditional factors in determining whether a cease-and-desist order is an appropriate sanction based on the entire record. Many of these factors are akin to those used by courts in determining whether injunctions are appropriate, including the seriousness of the violation, the isolated or recurrent nature of the violation, the respondent's state of mind, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the respondent's opportunity to commit future violations. In addition, we consider whether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, and the remedial function to be served by the cease-and-desist order in the context of any other sanctions being sought in the same proceedings.

74 SEC Docket at 436.

The evidence demonstrates that it is necessary to order EY to cease and desist in order to protect public investors and the capital markets. Based on my observation of the witnesses and my review of record, I conclude that EY will likely commit future violations absent an explicit directive to cease and desist. Although EY has sold its consulting practice and certain partners have retired, many EY partners, who either committed the violations or knew about them and did nothing to stop them, are still at EY: Mr. Fisher in tax, Mr. Frick and Mr. Paradis in audit, Mr. Coulson, and unnamed persons in both the national office on independence and legal department. In addition, the evidence shows that EY has an utter disdain for the Commission's rules and regulations on auditor independence. In their testimony, Mr. Bishko, a retired partner, Mr. Coulson, and Mr. Frick, present partners, were at times argumentative, sarcastic, and not forthcoming.[55]

A second compelling reason why a cease-and-desist order is required is that the Commission has tried and failed to bring EY into compliance through litigation. As noted previously, in 1995, the United States District Court for the Northern District of Texas entered a Final Order that contained the terms of a settlement where EY agreed with respect to its future activities that:

> Ernst & Young undertakes to, and shall, comply with standards and guidelines issued by the Commission and the accounting profession regarding the independence of public accountants that audit the financial statements of any issuer whose securities are registered with the Commission pursuant to Section 12 of the [Exchange Act] relating to loans, leases, and other business relationships with audit clients as specified in the Codification of Financial Reporting Policies Section 602.02.g.

SEC v. Ernst & Young, Civil Action No. 3-91-2267-X (N.D. Tx. 1995) in evidence as Div. Ex. 246. In June 2002, the Commission censured a Dutch accounting firm that was a member of EY International because the firm lacked independence due to its joint business relationships with an audit client that was a software company. Moret Ernst & Young Accountants, 77 SEC Docket 3416 (June 27, 2002) in evidence as Div. Ex. 453.

In addition, the persuasive evidence in this record is that EY is neither implementing, nor does it have in place, policies and procedures that can reasonably be expected to ensure compliance with independence rules in business dealings with audit clients. The TOS Report, which found that EY's systems and controls designed to achieve compliance with independence rules were effectively designed and implemented as of June 30, 2001, and that they operated effectively from June 30, 2001, to December 31, 2001, is a consideration. However, the TOS authors did not view the evidence in this record, and the TOS Report is not dispositive on the issue of whether EY will likely violate the independence rules in the future.

[55] Mr. Bishko refused to comply with a subpoena requiring him to testify on March 18, 2003, and the hearing had to be postponed until he appeared voluntarily on March 21, 2003.

EY's violations occurred over a prolonged time period and concerned matters that are significant to public investors and the capital markets. Congress affirmed that auditor independence is one of the paramount conditions that auditors must observe by enacting the Sarbanes-Oxley Act. A Senate Report on the legislation states:

> The statutory independent audit requirement has two sides. It grants a franchise to the nation's public accountants – their services, and only their services, and certification, must be secured before an issuer of securities can go to market, have the securities listed on the nation's stock exchanges, or comply with the reporting requirements of the securities laws. This is a source of significant private benefit to the public accountants.
>
> But the franchise is conditional. It comes in return for the CPA's assumption of a public duty and obligation. As a unanimous Supreme Court noted nearly 20 years ago: "In certifying that public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility. [That auditor] owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."

S. Rep. No. 107-205, at 14 (2002) (citing United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984) (emphasis in original).

EY committed repeated violations of the auditor independence standards by conduct that was reckless, highly unreasonable, and negligent. It has not acknowledged that it has committed any violations, and it has offered no assurance that it will not commit violations in the future.

For all the above reasons, I find the public interest requires a cease-and-desist order to secure compliance.

Disgorgement

Section 8A(e) of the Securities Act and Section 21C(e) of the Exchange Act authorize the Commission to order disgorgement, including reasonable interest, in any cease-and-desist proceeding where there is a finding that someone is violating, has violated, or is about to violate any provision of any statute, rule, or regulation.

The Division recommends that EY be ordered to disgorge $1,686,500, the amount of EY's fees for auditing PeopleSoft for fiscal years 1994 through 1999, and prejudgment interest totaling $729,302.13.[56] (Stipulations.) According to the Division, equity requires that EY disgorge its audit fees that amount to "but a fraction of the nearly half a **B**illion dollars of revenues EY obtained through its consulting and other business relationships with PeopleSoft

[56] The parties stipulated to the amount of EY's audit fees, but the Division did not show how it calculated the amount of prejudgment interest. (Stipulations; Div. Initial Brief at 125.)

that caused" EY to violate the independence regulations. (Div. Initial Brief at 116) (emphasis in original). In support of its position, the Division cites SEC v. Hughes Capital, 124 F.3d 449, 455 (3d Cir. 1997) (quoting SEC v. First City Financial Corp., 890 F.2d 1215, 1230 (D.C. Cir. 1989) (disgorgement "is an equitable remedy designed to deprive a wrongdoer of his unjust enrichment and to deter others from violating the securities laws.") and SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1104 (2d Cir. 1972) ("The effective enforcement of the federal securities laws requires that the SEC be able to make violations unprofitable.") (Div. Initial Brief at 115.)

Based on the evidence, disgorgement is warranted to prevent unjust enrichment and to deter EY and others from committing similar violations. "The deterrent effect of an SEC enforcement action would be greatly undermined if securities law violators were not required to disgorge illicit profits." Manor Nursing Centers, 458 F.2d at 1104. This was not a situation of an isolated mistake or confusion over a complicated, technical issue. These violations occurred over an extended period. They were committed by professionals throughout the firm who exhibited no caution or concern for the rules of auditor independence in connection with business relationships with an audit client. I therefore will order that EY disgorge $1,686,500, the amount of its fees for auditing PeopleSoft for fiscal years 1994 through 1999, and prejudgment interest from April 1, 2000, the first day of the month following March 30, 2000, the day PeopleSoft filed its Form 10-K for fiscal year ended December 31, 1999. (Div. Ex. 549 at 041936.)

Requiring An Independent Consultant

Section 8A of the Securities Act and Section 21C of the Exchange Act authorize the Commission to supplement a cease-and-desist order with a requirement that such person:

> comply, or to take steps to effect compliance, with such provision, rule, or regulation, upon such terms and conditions and within such time as the Commission may specify in such order. Any such order may, as the Commission deems appropriate, require future compliance or steps to effect future compliance, either permanently or for such period of time as the Commission may specify, with such provision, rule, or regulation with respect to any security, any issuer, or any other person.

The Division recommends that the Commission use this authority to require EY to hire an independent consultant acceptable to the Division. The independent consultant would: (1) review EY's auditor independence policies, procedures, and practices regarding its business relationships with audit clients, including the business relationships set out in this Initial Decision; (2) review all of EY's business relationships with audit clients from which EY and/or its audit client received revenues over $100,000 (exclusive of audit fees) during any calendar year since January 1, 2000, or such other threshold set by the independent consultant after consultation with the Division and EY; and (3) determine whether any such relationship violated the auditor independence requirements established by the Commission and GAAS.

The Division recommends that within six months of the date of the Initial Decision, the independent consultant shall submit a report documenting its findings and making recommendations (the "Report") to EY, the Division, and the Chief Administrative Law Judge.

The Report will include recommendations necessary to remedy the failures found in the Initial Decision and any additional failures found in the Report. EY shall adopt all recommendations in the Report; provided however, that EY may suggest an alternative policy or procedure designed to achieve the same result in writing to the independent consultant, the Division, and the Chief Administrative Law Judge. EY and the independent consultant shall negotiate in good faith any recommended policy or practice as to which there is dispute. EY shall adopt the recommendations the independent consultant deems appropriate. Finally, the Division recommends that within forty-five days of receiving the independent consultant's written Report, EY shall file an affidavit with the Division and the Chief Administrative Law Judge certifying that it has implemented the independent consultant's recommendations. (Div. Initial Brief at 125-26, clarified by the Division's Motion To Supplement the Record, December 18, 2003.) The Division points to Peat Marwick Mitchell & Co., 45 S.E.C. 789 (July 2, 1975), as an example of an order entered on consent that imposed various remedial sanctions on a firm. (Div. Initial Brief at 124 n.53 (citing Moret Ernst & Young Accountants, 77 SEC Docket 3416 (June 27, 2002) (settlement order); Syncor International Corp., 79 SEC Docket 378 (Dec. 10, 2002) (settlement order); DeGeorge Financial Corp., 65 SEC Docket 2608 (Nov. 12, 1997) (settlement order)).)

EY considers the requirement that it retain an independent consultant as an "outrageous" attempt to punish EY for alleged transgressions that happened several years ago that is unsupported by any record evidence. (EY Brief at 149-50.) EY cites several cases for the proposition that relief pursuant to Rule 102(e) of the Commission's Rules of Practice and Sections 4C and 21C of the Exchange Act must be remedial in nature, rather than punitive, must be tailored to the challenged conduct at issue, and must be directed toward preventing future harm to the investing public and the Commission's processes. (EY Brief at 126 (citing County of Nevada, 70 SEC Docket 3303, 3334-35 (Oct. 29, 1999); Warren G. Trepp, 65 SEC Docket 614 (Aug. 18, 1997).) According to EY, there has been no harm to the investing public, and EY had reasonable policies and procedures in place to address independence issues and these processes worked. In addition, EY claims that subsequent events such as the end of EY/GEMS for PeopleSoft, the sale of EY's consulting practice, the TOS report, and the provisions of the Sarbanes-Oxley Act, make any sanction unwarranted. (EY Brief at 127, 140-49.)

Section 8A of the Securities Act and Section 21C of the Exchange Act specify that the Commission may take actions in addition to an order to cease and desist to achieve compliance. The record demonstrates that it is in the public interest for the Commission to exercise this authority as a means of obtaining compliance with the Commission's independence rules. Despite EY's strong denials, the evidence shows that the firm paid only perfunctory attention to the rules on auditor independence in business dealings with a client, and that EY reliance on a "culture of consulting" to achieve compliance with the rules on auditor independence was a sham. EY has offered no promises of future compliance. I reject EY's argument that intervening events make sanctions unnecessary. Congress in the Sarbanes-Oxley Act reaffirmed the Commission's responsibility to act vigorously to eliminate improper professional conduct by codifying the provisions of Rule 102(e) in Section 4C of the Exchange Act. I have previously rejected EY's claims that: (1) it had reasonable policies and procedures in place, which it implemented reasonably to assure compliance with auditor independence standards in business

relationships; and (2) the TOS Report provides assurance that EY will comply with the independence rules in the future.

I accept the Division's recommended sanction as appropriate, however, I will order a less detailed requirement for the independent consultant and shift oversight responsibility to the Commission so that it can delegate that responsibility to whomever it deems appropriate.

Six-Month Suspension

The Division recommends that the Commission, pursuant to Section 4C of the Exchange Act and Rule 102(e) of the Rules of Practice, suspend EY:

> from accepting audit engagements for new SEC registrant audit clients for a period of six months from the date of this Order, or, if not accomplished before that date, until such date on which it demonstrates, to the satisfaction of the Chief Administrative Law Judge, that it has implemented procedures sufficient to comply with this Order.

(Div. Initial Brief at 126.)

EY opposes the suspension for many of the same reasons it opposed the independent consultant. It characterizes the Division's recommendation as outrageous and unprecedented. It notes that Peat Marwick was a settlement that did not involve audit failures. EY argues that the requested relief is unsupported by the record and is an attempt to punish EY for alleged independence transgressions that happened many years before. EY argues that Commission precedent in cases involving serious audit failure, which were not present here, do not support a six-month, firm-wide suspension. In Ernst & Ernst, 46 S.E.C. 1234 (May 31, 1978), the Commission reversed an administrative law judge's finding that an accounting firm should be barred from Commission practice with respect to new clients for six months. In Ernst & Whinney, 47 SEC Docket 291 (June 28, 1990), the administrative law judge rejected the Division's request for a firm-wide suspension and ordered a forty-five day suspension on the firm's local office that contributed to the audit failure. (EY Brief at 151.)

The Commission has repeatedly stated that the assessment of the proper sanctions to be imposed depends "on [the] particular facts and circumstances, and cannot be determined in comparison with the actions taken in other cases." Stonegate Securities Inc., 76 SEC Docket 111, 118 n.22 (Oct. 15, 2001.) Here considerable evidence shows that EY partners acted recklessly and negligently in committing willful and deliberate violations of well-established rules that govern auditor independence standards in connection with business relationships with an audit client. EY's misconduct was blatant and occurred after the Commission and a court accepted EY's representations that it would observe the very same auditor independence rules, that it now claims are too vague to be followed. There is nothing in this record that shows that EY is willing to accept the auditor independence rules applicable to business relationships with audit clients. EY has not acknowledged any wrongdoing and it has made no commitment to lawful conduct.

Congress gave the Commission authority to suspend EY from accepting audit engagements for new SEC registrant audit clients. I find that the record demonstrates that it is in the public interest for the Commission to exercise its authority as a means of obtaining compliance with the Commission's independence rules. I therefore will suspend EY from accepting audit engagements for new SEC registrant audit clients for a period of six months.

VI. RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I certify that the record includes the items described in the record index issued by the Secretary of the Commission on February 4, 2004, and the additional exhibits I admitted into evidence in this Initial Decision.

VII. ORDER

Based on these findings and conclusions:

I ORDER, pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934, that:

A. Ernst & Young LLP shall cease and desist from committing any violations and any future violations of Rule 2-02 of Regulation S-X, and from causing any violations and any future violations of Sections 7(a) and 10(a) of the Securities Act of 1933, and Sections 13(a) and 14(a) of the Securities Exchange Act of 1934, and Rules 13a-1 and 14a-3 thereunder.

B. Ernst & Young LLP shall disgorge the sum of $1,686,500, and prejudgment interest, calculated from April 1, 2000, through the last day of the month preceding the month in which payment is made pursuant to Commission Rule 600.[57] 17 C.F.R. § 201.600.

Ernst & Young LLP shall pay disgorgement and prejudgment interest on the first day following the day this Initial Decision becomes final by United States postal money order, wire transfer, certified check, bank cashier's check, or bank money order payable to the U.S. Securities and Exchange Commission. Payment with a cover letter should identify Ernst & Young LLP as the Respondent in Administrative Proceeding No. 3-10933, and should be delivered by hand or courier to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, Virginia 22312. A copy of the cover letter should be sent to the Commission's Division of Enforcement.

C. Ernst & Young LLP shall retain an independent consultant acceptable to the Commission, to work with Ernst & Young LLP to assure the Commission that Ernst & Young LLP's leadership is committed to, and has implemented policies and procedures that reasonably can be expected to remedy the violations found in this Initial Decision and result in compliance

[57] Rule 600(b) of the Commission's Rules of Practice prescribes the underpayment rate of interest established under 26 U.S.C. § 6621(a)(2) and that interest on the sum to be disgorged shall be compounded quarterly. 17 C.F.R. § 201.600(b).

with the Commission's rules on auditor independence related to business relationships with clients and with GAAS. Ernst & Young LLP shall cooperate with the independent consultant in all respects, including staff support, and shall compensate the independent consultant, and staff, if one is necessary, at reasonable and customary rates. Once retained, Ernst & Young LLP shall not terminate the relationship with the independent consultant without Commission approval. The independent consultant shall report to the Commission in writing six months from the date work has begun as to the findings of its review and Ernst & Young LLP's efforts at correcting the violations.

I FURTHER ORDER, pursuant to Section 4C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, that Ernst & Young LLP is suspended from accepting audit engagements for new Commission registrant audit clients for a period of six months from the date this Initial Decision becomes effective.

This order shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that rule, a petition for review of this Initial Decision may be filed within twenty-one days after service of the decision. It shall become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule 360(d)(1) within twenty-one days after service of the Initial Decision upon such party, unless the Commission, pursuant to Rule 360(b)(1), determines on its own initiative to review this Initial Decision as to any party. If a party timely files a petition for review, or the Commission acts to review as to a party, the Initial Decision shall not become final as to that party.

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Brenda P. Murray
Chief Administrative Law Judge